In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1222

AARON KRAUT, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question presented is whether the courts below properly held that only a portion of the gain petitioners realized from sale of their business to a tax-exempt charity qualified as capital gains.

The pertinent facts are as follows: Aaron and Harry Kraut developed a new type of insulation for wire used in the manufacture of Christmas tree lights and formed a corporation, Nassau Plastic and Wire Corporation, to manufacture the electric wire. While Nassau's stock was owned by the Krauts' wives, Harry and Aaron effectively controlled Nassau's affairs. After one year of operation, the Krauts entered into an agreement to sell the Nassau stock to the Cathedral of Tomorrow,

a tax-exempt religious organization (Pet. App. II A29-A30).

During its first year of operation, Nassau had reported taxable income of less than $16,000 and had a year-end net worth of only $12,548.62. Nevertheless, the Cathedral agreed to pay a minimum of $500,000 to a maximum of $3,500,000 for Nassau's stock. The Cathedral, however, was not obligated to meet this purchase price from any source other than income earned by Nassau over a ten-year period, 75 percent of which was to be paid to the Krauts as the "purchase price." Inasmuch as the Cathedral was tax exempt, these purchase payments were to be made from Nassau's pre-tax income. The Krauts' only remedy in the event the Cathedral's payments failed to satisfy the minimum price requirements set forth in the sales contract was to reclaim Nassau (Pet. App. I A10, A16; Pet. App. II A30-A31 and n. 3, A32, A38).

After the transfer of the stock, the Cathedral immediately hired Aaron and Harry to manage Nassau and, under the Kraut brothers' stewardship, Nassau enjoyed two relatively successful years. During these two years, Cathedral made payments totalling $1,480,000 pursuant to the purchase contract. Petitioners reported these payments as capital gains. The Commissioner concluded that the Nassau stock transferred to the Cathedral had a fair market value of $168,445.60 as of the date of transfer, so that only $168,445.60 of the amounts received by petitioners could be considered as proceeds from the sale of that stock subject to taxation at capital gains rates (Pet. App. II A31, A32).

The Tax Court upheld the Commissioner's determination. It ruled that no sale of property had occurred. However, in the absence of timely filed pleadings seeking greater deficiencies in taxes than those initially deter-

mined, the Tax Court held that the Commissioner was bound by the deficiencies as determined. Accordingly, the Tax Court held that $168,445.60 of the amounts received from the Cathedral were the proceeds realized from the sale of capital assets (Pet. App. I A25-A26).

The court of appeals affirmed, holding that the preferential capital gains rates ought to be accorded to the proceeds of the sale only to the extent that they represented amounts a nonexempt purchaser would have paid for the Nassau stock. The court further held that petitioners had failed to show that any nonexempt purchaser would have paid more for the stock than the amount determined by the Commissioner (Pet. App. II A27-A40).

1. In *Commissioner* v. *Brown*, 380 U.S. 563, this Court held that the taxpayer's transfer of a business to a charity in return for a "purchase price" payable out of the income the charity earned from the business constituted a sale of that business so that the seller's gain under this agreement constituted capital gain. The Court noted (380 U.S. at 572):

> Congress intended to afford capital gains treatment only in situations "typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134. It was to "relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments" that capital gains were taxed differently by Congress. *Burnet* v. *Harmel*, 287 U.S. 103, 106; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265.

Because the business transferred in *Commissioner* v. *Brown, supra,* had been sold for a fixed price within a reasonable range of its market value (380 U.S. at 573-574), taxing the gain realized on the transaction as capital gains would be consistent with the policies underlying the statute (*id.* at 572-573):

> Obviously, on these facts, there had been an appreciation in value accruing over a period of years, *Commissioner* v. *Gillette Motor Co., supra,* and an "increase in the value of the income-producing property." *Commissioner* v. *P G. Lake, Inc., supra,* at 266. This increase taxpayers were entitled to realize at capital gains rates on a cash sale of their stock * * *.
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> In the actual transaction, the stock was transferred for a price payable on the installment basis but payable from the earnings of the company. Eventually $936,131.85 was realized by respondents. This transaction, we think, is a sale, and so treating it is wholly consistent with the purposes of the Code to allow capital gains treatment for realization upon the enhanced value of a capital asset.

As both courts below noted, petitioners' sale of Nassau stock was significantly different from the sale considered in *Commissioner* v. *Brown, supra.* Here, the purchase price agreed upon was far in excess of the range of reasonable market value. Accordingly, petitioners' gain here represented in part something quite different from the realization of "appreciation in value accrued over a substantial period of time." In holding that petitioners could only take advantage of the capital gains rates to the extent that the purchase price fell within the reasonable range of market value, the courts below fully complied with this Court's implicit directive in *Commissioner* v. *Brown,* and gave full effect to the tax policies this Court found expressed in the capital gains provisions. As the

court of appeals recognized (Pet. App. II A33-A34), to the extent the price exceeds the amount that a nonexempt purchaser would pay, it does not represent the past accrued appreciation that the capital gains provisions seek to shield from taxation at ordinary rates and thus is not part of the proceeds of a sale under Section 1222(3) of the Code. See *Berenson* v. *Commissioner*, 507 F.2d 262 (C.A. 2).

In 1969 Congress enacted Sections 512(b)(4) and 514 of the Internal Revenue Code, which substantially eliminate future litigation of the type involved in *Brown*. Those statutes effectively preclude a tax-exempt organization from paying more than fair market value for any business it might attempt to acquire under circumstances similar to those here.

2. Contrary to petitioners' further argument (Pet. 18-23), they were not denied the opportunity to demonstrate that the Commissioner's valuation of the Nassau stock was incorrect. Instead, as the court of appeals noted, they simply failed to do so. The Commissioner valued the Nassau stock on the reasonable basis of the income it earned during the only taxable year it existed prior to sale. In attempting to rebut the Commissioner's valuation, petitioners relied solely upon Aaron Kraut's testimony as to the corporation's potential. But the Tax Court refused to give any weight to his testimony, characterizing his memory as "narrowly selective" and "seemingly self-serving," and his testimony as "contrived" (Pet. App. I A19 and n.7).

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

APRIL 1976.

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